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DESCRIPTION OF REVENUE RECONCILIATION PROPOSAL BY CHAIRMAN ROSTENKOWSKI

Scheduled for Markup

by the

HOUSE COMMITTEE ON WAYS AND MEANS

on July 11, 1989

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of a revenue reconciliation proposal by Chairman Rostenkowski. The proposal is scheduled for markup consideration by the Committee on Ways and Means on July 11, 1989.

The first part of the document is a description of Administration tax proposals included in the Chairman's proposal. The second part describes Administration proposals as modified in the Chairman's proposal, and the third part describes other revenue provisions in the Chairman's reconciliation proposal.

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[1] This document may be cited as follows: Joint Committee on Taxation, Description of Revenue Reconciliation Proposal by Chairman Rostenkowski (JCX-28-89), July 11, 1989.

I. ADMINISTRATION PROPOSALS

A. Suspend Automatic Reduction in Airport and Airway Trust Fund Taxes

Present Law

The excise taxes imposed on air transportation for transfer to the Airport and Airway Trust Fund are (1) an 8 percent tax on air passenger transportation (Code sec. 4261(a), (b)), (2) a 5 percent tax on air freight (sec. 4271), (3) a $3 per passenger tax on international departures (sec. 4261(c)), (4) taxes on noncommercial aviation fuels of 3 cents-per-gallon of gasoline (secs. 4041(c)(2)) and 14 cents per gallon of jet fuel (sec. 4041(c)(1) and 4041(e)), and (5) a 9 cents-per-gallon tax on gasoline used in noncommercial aircraft (sec. 4081).

These taxes apply through December 31, 1990. The Airport and Airway Revenue Act of 1987 provided, however, that the taxes would be reduced in calendar year 1990 as described in this paragraph if the appropriations from the Trust Fund for fiscal years 1988 and 1989 for airport improvements, facilities and equipment, and research, engineering and development, were less than 85 percent of the total amounts authorized for these programs for fiscal years 1988 and 1989. The 8 percent passenger tax, the 5 percent freight tax, and the noncommercial jet fuel tax would each be reduced by 50 percent (sec. 4283). The 3 cents-per-gallon additional tax on noncommercial aviation gasoline would be eliminated (sec. 4283). Three cents per gallon of the 9 cents-per-gallon gasoline tax would be refunded or credited to ultimate purchasers using the gasoline in noncommercial aviation (sec. 6427(q)). The $3 international departure tax would not be affected. The reductions in excise taxes described in this paragraph are sometimes referred to as the "trigger".

Funding for FAA operations and maintenance from the Trust Fund is limited to 50-percent of the total appropriated for airport improvements, facilities and equipment, and research, engineering and development. In addition, if the appropriated amount is less than the amount authorized for these programs, the amount available from the Trust Fund for operations and maintenance is limited further by twice the amount of such shortfall. This further reduction is sometimes referred to as the "penalty".

Explanation of Proposal

The trigger would be suspended for one year. Approximately $976 million of the estimated net increase in budget receipts in calendar year 1990 due to the suspension would remain in the general fund, instead of being deposited in the Trust Fund; these receipts would be available to be spent for FAA operations and maintenance. A portion of this amount would be equivalent to twice the shortfall between authorized and appropriated amounts in fiscal year 1990 for airport improvements, facilities and equipment, and research, engineering and development. The remainder would be equivalent to the increase in appropriations in fiscal year 1990 for airport improvements over the $1.4 billion appropriated for airport improvements in fiscal year 1989, to provide a further incentive to the Appropriations Committee to increase such appropriations.

It is anticipated that the Appropriations Committee would increase the appropriation for airport improvements to $1.5 billion for fiscal year 1990; $100 million of this amount would be earmarked for airport gate access security or discretionary capacity funding. In addition, it is anticipated that the Appropriations Committee would increase the appropriation for facilities and equipment to at least $1.7 billion for fiscal year 1990 (approximately a 23 percent increase over fiscal year 1989). The Appropriations Committee is also expected to indicate (in strong Committee Report language) its intention to increase spending for this purpose substantially in the next several years.

It is anticipated that the Administration would indicate its concurrence with this proposal by a letter to the Chairman. In addition, the Administration would indicate that it would use its best efforts to request: (1) fiscal year 1991 funding for airport improvements at least 10 percent above the 1990 appropriation level and (2) fiscal year 1991 funding for each account within the transportation budget function at least equal to 1990 appropriation levels.

Effective Date

The provision would be effective on January 1, 1990.

Revenue Effect

The provision would increase net fiscal year budget receipts by $851 million in fiscal year 1990, and $269 million in fiscal year 1991.

B. Administration Loophole Closer Proposals

1. Change tax treatment of certain high-yield original issue discount (OID) obligations

Present Law

Original issue discount (OID) is the excess of the stated redemption price at maturity over the issue price of a debt instrument. The issuer of a debt instrument with OID generally accrues and deducts the discount, as interest, over the life of the obligation even though the amount of such interest is not paid until the debt matures. The holder of such a debt instrument also generally includes the OID in income on an accrual basis.

A shareholder must generally include in income a distribution with respect to preferred stock (sec. 305(b)). Pursuant to regulations issued under section 305(c), a distribution with respect to preferred stock generally includes the difference between the issue price and redemption price of preferred stock (to the extent such difference represents a reasonable redemption premium). Such a distribution is generally included in income over the term of the preferred stock. A corporation may not generally deduct dividends with respect to stock.

Explanation of Proposal

Certain OID instruments and instruments that allow for the payment of interest with additional instruments of the issuer (e.g., so-called "payment-in-kind (PIK)" bonds) would be treated as preferred stock for Federal income tax purposes. The provision would apply to any debt instrument that is issued by a corporation and has a term of five years or more, is issued at a deep discount, and has a yield in excess of 5 percentage points over the applicable Federal rate. An instrument would be considered as having a "deep discount" if its stated redemption price at maturity is significantly greater than its issue price. Special rules would apply to instruments that provide for both stated interest and OID.

The provision would not alter the ability of the IRS to classify, as equity, purported debt instruments under general tax principles. Authority would be granted to the Secretary of the Treasury to prescribe regulations that are necessary and appropriate to carry out the purposes of this provision, including regulations that deal with arrangements designed to avoid the application of this provision and regulations that deal with complex instruments.

Effective Date

The provision would be effective for instruments issued after July 10, 1989. The provision would not apply to instruments the terms of which are subject to a binding written contract entered into, or a tender offer made, on or before July 10, 1989.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $25 million in 1990; $51 million in 1991; $94 million in 1992; $131 million in 1993; and $160 million in 1994.

2. Consolidated computation of earnings and profits for corporations filing consolidated returns

Present Law

A corporate distribution to a shareholder is a dividend to the extent of the distributing corporation's current or accumulated earnings and profits ("e&p"). Corporate recipients of dividends generally are entitled to a dividends received deduction equal to at least 70 percent of the dividend. (An 80-percent or 100-percent deduction is permitted if the recipient has sufficient ownership of the distributing corporation.)

If a group of corporations files a consoldiated return, taxable income is determined by reference to the income and deductions of all members of the group and is computed on a group-wide basis. No income is separately attributed to minority owners of a subsidiary. Thus, a subsidiary with positive income incurs no corporate level tax if its parent corporation has losses sufficient to offset that income, even though the subsidiary may have minority ownership. However, for purposes of determining whether the subsidiary has sufficient earnings and profits to pay a dividend, the subsidiary's earnings and profits are not reduced by any deficit in earnings and profits of the parent corporation.

Thus, a group of corporations filing a consolidated return may be able to pay a dividend to minority shareholders out of separate subsidiary earnings and profits, in situations where other members of the group have deficits in earnings and profits such that the group as a whole would have insufficient earnings and profits to pay a dividend if the group had operated as a single corporation. At the same time, because taxable income of the group is computed on a group wide basis, generally as if the group had operated as a single corporation, the separate taxable income of the subsidiary may be offset by losses of other members of the group so that the dividend paid from the subsidiary's separate earnings may not have borne any tax.

Explanation of Proposal

For purposes of determining whether any distribution during a year by a member of a group of corporations filing a consolidated return to a nonmember shareholder is treated as made from earnings and profits and thus constitutes a dividend to the shareholder (corporate or individual), earnings and profits is computed on a group wide basis. Thus, if a member of a group has earnings and profits but the group as a whole does not, a distribution by the member is not a dividend. Similarly, if the group as a whole has earnings and profits but a member of the group does not, a portion of the group's earnings and profits may be allocated to distributions made by the member.

Special rules are provided for earnings and profits of a member arising before that member joined the group, and for the allocation of earnings and profits to a member when it leaves the group. Special rules are also provided for priority allocation of certain earnings and profits to dividends with respect to grandfathered stock and for earnings and profits of a member accumulated before the effective date.

Effective Date

The provision would generally be effective after July 10, 1989. However, it would not apply to characterize distributions with respect to subsidiary stock issued on or before July 10, 1989.

Auction rate preferred stock would be treated for this purpose as issued when the contract requiring the auction became binding and would not be considered issued at the time of each auction conducted pursuant to such commitment.

An appropriate election would be provided to permit a group retroactively to adopt the proposal for all prior years.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $37 million in 1990, $77 million in 1991, $129 million in 1992, $176 million in 1993, and $229 million in 1994.

3. Limit nonrecognition on exchanges of property to property similar or related in service or use; restrict basis shifting techniques in like-kind exchanges; amend holding requirements for like-kind exchanges

Present Law

In general

An exchange of property, like a sale, generally is a taxable transaction. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a like-kind which also is to be held for productive use in a trade or business or for investment (sec. 1031).

In general, any kind of real estate is treated as of like kind with other real estate. By contrast, different kinds of personal property (e.g., equipment and vehicles) are not treated as of like kind. Certain types of property, such as inventory, stocks and bonds, and partnership interests, are not eligible for nonrecognition treatment under section 1031.

The like-kind standard contrasts with the standard under section 1033 providing for nonrecognition of gain upon certain involuntary conversions of property (e.g., through destruction, theft, seizure, or condemnation). Other than upon a condemnation of real estate (to which the like-kind standard applies), section 1033 permits nonrecognition of gain to involuntary conversions only if the taxpayer acquires replacement property that is similar or related in service or use to the converted property. This standard is significantly narrower than the like-kind standard. For example, unimproved and improved real estate generally are not considered similar or related in service or use.

Related party exchanges

If related parties engage in a like-kind exchange that qualifies for nonrecognition treatment under section 1031, a subsequent disposition of the property by the transferee generally will not affect the nonrecognition treatment of the original exchange. Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have engaged in like-kind exchanges in anticipation of the sale of low basis property in order to avoid the recognition of gain on the subsequent sale. Present law prevents the use of related party sales to avoid current recognition of gain in the case of installment sales. Under section 453 (relating to the installment method of reporting gain), if an installment sale between related parties is followed by certain dispositions of the property by the transferee, the gain reportable by the original seller will be accelerated.

Holding period requirements

In order to qualify for nonrecognition treatment under section 1031, both the property exchanged and the property received must be held for either use in a trade or business or for investment. In Bolker v. Commissioner, 760 F.2d 1039 (9th Cir. 1985), the court held that these holding requirements were met where the taxpayer received property in the liquidation of a corporation and exchanged it shortly thereafter for like-kind property.

Explanation of Proposals

1. The standard for nonrecognition under section 1031 would be conformed to the standard under section 1033 which applies for purposes of nonrecognition on involuntary conversions. Thus, in order to qualify for nonrecognition under section 1031, the property that is received must be "similar or related in service or use" to the property that is transferred. The like-kind standard also would be replaced with the "similar or related in service or use" standard in cases of a condemnation of real estate. Foreign real property would be treated as not similar or related in service or use to U.S. real property.

2. If a taxpayer directly or indirectly exchanges property with a related party (as defined for purposes of section 267) in a transaction otherwise qualifying for nonrecognition under section 1031, and the related party disposes of the property received by it within 2 years of the date of the transfer of the property by the taxpayer, then the original exchange would not qualify for nonrecognition under section 1031. Any gain or loss not recognized by the taxpayer as of the date of the original exchange would, subject to the loss limitation rules of section 267, be recognized by the taxpayer as of the date of the subsequent disposition by the related party. A disposition by the related party of the property received in the exchange would not invalidate the nonrecognition treatment of the original exchange if such disposition was due to the death of the related party or to the involuntary conversion of the property.

3. In order to qualify for nonrecognition under section 1031, the property that is exchanged must have been held for use in a trade or business or for investment for at least one year prior to the exchange, and the property that is received must be held for a purpose similar or related in service or use to that of the property relinquished for at least one year after the exchange.

Effective Date

The provisions would apply to transfers after July 10,

1989 (other than transfers pursuant to a written binding contract in effect on that date).

Revenue Effect

[Fiscal years, millions of dollars]

Proposal	1990	1991	1992	1993	1994	1990-94
Limit like-kind exchanges to similar use property	143	222	273	325	378	1,341
Restrict basis shifting techniques	100	120	130	140	151	641
Amend holding requirements	(*)	(*)	(*)	(*)	(*)	(*)

(*) Gain of less than $5 million.

4. Repeal special treatment provided certain personal injury liability assignments (structured settlements)

Present Law

Under present law, any amount received by an assignee for agreeing to a qualified assignment is excluded from gross income to the extent that the amount received does not exceed the aggregate cost of any qualified funding assets. A qualified assignment is any assignment of a liability to make periodic damage payments on account of a personal injury or sickness (in a case involving physical injury or physical sickness), provided the terms of the assignment satisfy certain conditions. Amounts received by an assignee from qualified funding assets are included in the gross income of the assignee, but a deduction is allowed to the assignee as payments are made to the injured person. This treatment of the assignee effectively exempts from tax the investment income earned from the funding assets.

Explanation of Proposal

The proposal would repeal the exclusion provided under present law for amounts received for agreeing to a qualified assignment. Consequently, the entire amount received for agreeing to a qualified assignment would be included in the gross income of the assignee for the taxable year in which the amount is received. The present-law treatment of the assignee with respect to amounts received from any funding asset and with respect to payments to the injured person would be retained.

Effective Date

The provision would apply to assignments entered into after July 10, 1989.

Revenue Effect

The provision is estimated to increase budget receipts by $107 million in 1990, $112 million in 1991, $118 million in 1992, $126 million in 1993, and $134 million in 1994.

5. Limit section 104 exclusion from income to amounts received for physical injury

Present Law

Under present law, gross income does not include any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness (sec. 104). Courts have interpreted this exclusion broadly in some cases to cover awards for personal injury that do not relate to a physical injury. For example, some courts have held that the exclusion applies to damages in cases involving employment discrimination and injury to reputation.

Explanation of Proposal

The application of the income exclusion would be limited to damages received on account of personal injuries or sickness in a case involving physical injury or physical sickness. If an action has its origin in a physical injury or physical sickness, then all damages that flow therefrom would be treated as payments involving physical injury or physical sickness. No allocation of damages would be required among multiple claims that are typically alleged in personal injury actions.

Effective Date

The proposal would be effective for damages received pursuant to decrees, settlements, or agreements entered into after July 10, 1989.

Revenue Effect

The proposal is estimated to increase fiscal year budget receipts by $4 million in 1990, $8 million in 1991 and 1992, $10 million in 1993, and $12 million in 1994.

6. Tax pre-contribution gain on certain in-kind partnership distributions

Present Law

Under present law, income, gain, loss and deduction with respect to property contributed to a partnership by a partner is required to be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time when it was contributed (sec. 704(c)). If appreciated property that was contributed to a partnership is sold, the partnership's gain generally is required to be allocated to the contributing partner, to the extent that the partner has not theretofore recognized pre-contribution appreciation in the property.

Present law does not provide the same result in the case of a distribution (rather than sale) of the contributed property, however. In general, gain is recognized upon a distribution from a partnership only to the extent that cash is distributed in excess of the partner's basis in his partnership interest. Thus, under present law, the pre-contribution gain may not be recognized by the contributing partner if the contributed property is distributed to another partner instead of sold by the partnership.

Explanation of Proposal

In the case of a distribution of contributed property, the contributing partner would be treated as recognizing gain or loss. The amount of gain or loss recognized by the contributing partner would be the amount that he would have been required to take into account if the partnership had sold the property at its fair market value at the time of the distribution, to the extent he had not previously taken into account the pre-contribution gain or loss. Gain or loss recognition would not be required, however, to the extent property is distributed back to the partner or partners who contributed the property.

The legislative history would provide that a constructive termination of the partnership would not change the application of section 704(c) (as modified by the proposal) to pre-contribution gain or loss with respect to previously contributed property, and that a constructive termination would not cause gain or loss recognition under the proposal.

Effective Date

The provision would be effective for contributions of property to a partnership after July 10, 1989, in taxable years ending after such date.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $5 million in 1990, $10 million in 1991, $10 million in 1992, $11 million in 1993, and $11 million in 1994.

7. Limit nonrecognition treatment when securities are received in certain section 351 transactions

Present Law

No gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control of the corporation (sec. 351). A transferor may thus transfer property to a corporation in exchange for a debt obligation of the corporation that is a security, without recognition of any gain.

The rules with respect to securities under section 351 differ from the rules under that section for debt obligations that are not considered to be "securities." Such other debt obligations are treated as "boot." A transferor who receives boot is taxed on the lesser of the amount of the boot or the gain realized on the exchange. In addition, the receipt of any debt obligation constituting boot is treated as an installment sale.

Explanation of Proposal

Securities received in certain section 351 transactions would be treated as boot and subject to installment sale treatment. The provision would apply to section 351 transactions where either (1) the holder of the securities is substantially protected against the risks of the issuer's business by an arrangement (including, for example, a letter of credit, a third-party guarantee, a put to a third party, or segregation of the issuer's assets to secure repayment of the indebtedness) which arises as part of the section 351 transaction, or (2) the value of stock received by the transferor in the exchange is less than 25 percent of the total value of all property (including stock, securities and boot) received by the transferor in the exchange. For purposes of this rule, indebtedness of the corporation is to be valued at its adjusted issue price.

Effective Date

The provision would apply to transfers after July 10, 1989.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $105 million in 1990, $165 million in 1991, $168 million in 1992, $159 million in 1993 and $81 million in 1994.

II. MODIFIED ADMINISTRATION PROPOSALS

A. Petroleum Tax for Oil Spill Liability Trust Fund

Present Law

Present law (Code sec. 4611) establishes an excise tax at the rate of 1.3 cents per barrel on domestic crude oil and imported petroleum products (including imported crude oil) for the purpose of funding the Oil Spill Liability Trust Fund. However, the tax will not be imposed until the enactment of qualified authorizing legislation.[2] Although the tax itself was enacted in 1986, qualified authorizing legislation has not yet been enacted. Consequently, this tax has never been collected.

The tax on domestic crude oil would be imposed on the operator of any United States refinery receiving such crude oil, while the tax on imported petroleum products would be imposed on the person entering the product into the United States for consumption, use, or warehousing. If domestic crude oil were used in, or exported from, the United States before imposition of the tax on the operator of a refinery, the tax would be imposed on the user or exporter of the oil.

Repayable advances could be made to the Trust Fund from the general fund of the Treasury in a maximum outstanding amount of $500 million. The maximum amount which could be paid from the Trust Fund for any single incident is $500 million, no more than $250 million of which could be used to pay for natural resource damage claims (sec. 9509(c)). Certain costs incurred by the Federal Government for oil spill removal are authorized by the Federal Water Pollution Control Act and the Intervention on the High Seas Act and are permissible Trust Fund expenditure purposes which, although subject to appropriation, do not require the enactment of the qualified authorizing legislation which is necessary to commence collection of the 1.3-cents-per-barrel excise tax.

The Oil Spill Liability Trust Fund excise tax is scheduled to expire on December 31, 1991. The tax will terminate earlier than that date if the Secretary of the Treasury determines that $300 million has been credited to the Trust Fund before January 1, 1992.

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[2] The Code (sec. 4611(f)) requires that the authorizing legislation must be substantially identical to subtitle E of title VI, or subtitle D of title VIII, of H.R. 5300 of the 99th Congress as passed the House of Representatives.

Explanation of Proposal

The proposal would modify present law to impose the tax at a rate of 3 cents per barrel and to commence collection of the tax for the Trust Fund expenditure purposes which under present law do not require the enactment of qualified authorizing legislation. Upon the enactment of qualified authorizing legislation, Trust Fund amounts could be available for additional expenditure purposes. As under present law, collection of the tax would cease December 31, 1991, or earlier if $300 million had been credited to the Trust Fund.

The Administration has recommended amending the present-law Oil Spill Liability Trust Fund excise tax by imposing the tax commencing on the first day of the first month beginning more than 30 days after the date of enactment of qualifying authorizing legislation. The Administration also has recommended extending the expiration date of the tax from December 31, 1991, to June 30, 1994.

Effective Date

The provision would require the collection of the tax to commence on October 1, 1989.

Revenue Effect

The provision is estimated to increase net fiscal year budget receipts by $69 million in 1990, $122 million in 1991, and $41 million in 1992.

B. Extension of the Telephone Excise Tax; Modification of Tax Collection Period

Present Law

Imposition of tax

A 3-percent excise tax is imposed on amounts paid for local and toll (long-distance) telephone service and teletypewriter exchange service (sec. 4251). The tax is collected by the provider of the service from the consumer (business and personal service). The tax is scheduled to expire after December 31, 1990.

The 3-percent telephone excise tax was last extended for 3 years (1988-1990) in the Omnibus Budget Reconciliation Act of 1987. The 3-percent tax was previously extended for 2 years (1986-1987) in the Deficit Reduction Act of 1984.

Collection of tax

Under present law, the telephone tax billed to the customer in a semi-monthly period is considered to be collected from the customer during the second following semi-monthly period. Such tax must be deposited in a Federal Reserve Bank or other authorized depository within 3 banking days after the end of the semi-monthly period for which the tax is considered collected. (Rev. Proc. 76-45, 1976-2 C.B. 668).

Explanation of Proposal

Extension of tax

The 3-percent telephone excise tax would be extended for one year (through December 31, 1991). The Administration's budget proposal recommended making the tax permanent.

Modification of collection period

Under the proposal, the tax for a semi-monthly period would be considered collected during the first week of the second following semi-monthly period. The tax would be required to be deposited within 3 banking days after the end of the week for which such tax is considered to be collected.

Effective Date

The proposal to extend the telephone excise tax would be effective on January 1, 1991. The proposal with respect to the time the tax is considered collected would be effective with respect to taxes considered collected for semi-monthly periods beginning after June 30, 1990.

Revenue Effect

(Fiscal years, millions of dollars)

Proposal	1990	1991	1992	1993	1994	1990-94
Extend 3% telephone excise tax for one year	--	1,612	1,003	--	--	2,615
Modification of collection period	102	7	-109	--	--	---

III. OTHER REVENUE PROPOSALS

A. Employee Stock Ownership Plan (ESOP) Proposals

Present Law

Leveraged ESOPs

Present law generally prohibits loans between a qualified plan and a disqualified person (sec. 4975). An exception to this rule is provided in the case of an employee stock ownership plan (ESOP). Thus, employer securities held by an ESOP may be acquired through direct employer contributions or with the proceeds of a loan from the employer or guaranteed by the employer.

If employer securities are acquired by an ESOP with loan proceeds, the ESOP is referred to as a leveraged ESOP. The ESOP may borrow directly from a financial institution (typically with a guarantee from the employer), or the employer may borrow from a financial institution and in turn lend the funds to the ESOP which then uses them to acquire employer securities. The employer securities are typically pledged as securities for the loan. The employer makes contributions to the ESOP which are then used to repay the acquisition loan. Shares that are acquired with an acquisition loan are allocated to the accounts of ESOP participants as the loan is repaid.

Interest exclusion for ESOP loans

A bank, an insurance company, a corporation actively engaged in the business of lending money, or a regulated investment company may exclude from gross income 50 percent of the interest received with respect to a "securities acquisition loan" used to acquire employer securities for an ESOP (sec. 133). A "securities acquisition loan" is generally defined as (1) a loan to a corporation or to an ESOP to the extent that the proceeds are used to acquire employer securities for the ESOP, or (2) a loan to a corporation to the extent that the corporation transfers an equivalent amount of employer securities to the ESOP and such securities are allocable to accounts of ESOP participants within 1 year of the date of the loan.

Dividends paid deduction

In certain circumstances an employer may deduct dividends paid on securities held by an ESOP to the extent the dividends are (1) paid out currently to plan participants or (2) used to repay a securities acquisition loan (sec. 404(k)).

Deferral of gain on certain sales of stock to an ESOP

Under present law, a taxpayer may elect to defer recognition of gain on the sale of certain qualified securities to an ESOP to the extent that the taxpayer reinvests the proceeds in qualified replacement property within a replacement period (sec. 1042). To be eligible for nonrecognition treatment (1) the qualified securities must be sold to an ESOP, (2) the ESOP must own, immediately after the sale at least 30 percent of the total value of the employer securities then outstanding (3) the ESOP must preclude allocation of assets attributable to qualified securities to certain individuals, and (4) the taxpayer must provide certain information to the Secretary.

Explanation of Proposals

1. The partial exclusion for interest received under section 133 would be repealed. This proposal is the same as the proposal contained in H.R. 2572, introduced by Chairman Rostenkowski on June 7, 1989.

2. The dividend deduction with respect to employer securities held by an ESOP would be repealed (sec. 404(k)).

3. The provision permitting deferral of recognition of gain on the sale of employer securities to an ESOP would be modified to provide that the deferral is available only if the taxpayer held the securitites for 3 years before the sale of the stock to the ESOP.

Effective Dates

As under H.R. 2572, the repeal of the partial interest exclusion would apply to loans made after June 6, 1989, including loans made after such date to refinance loans made on or before such date. The provision would not apply to any loan pursuant to a written binding commitment in effect on June 6, 1989, and at all times thereafter before such loan is made. This exception applies only to the extent that the proceeds of such loan are used to acquire employer securities pursuant to a written binding contract (or a tender offer registered with the Securities and Exchange Commission) in effect on June 6, 1989, and at all times thereafter before such securities are acquired.

In addition, the repeal would not apply to loans made to refinance loans made on or before June 6, 1989, or to loans made to refinance loans made after such date and that are grandfathered under the rules described above if (1) the outstanding principal of the loan is not increased by the refinancing, (2) the original lender was a lender that qualifies for the interest exclusion under section 133, and (3) the term of the loan is not extended, or the total period of the loan (including the term of the original loan and the refinanced loan) is not more than 7 years. Under the 7-year

rule, for example, the original loan could be for a term of 3 years, and the refinanced loan could extend the loan for no more than an additional 4 years without the loss of the partial interest exclusion.

With respect to the grandfather rule for certain loans made after June 6, 1989, the legislative history would provide that the existence of a written binding loan commitment can be demonstrated, for example, by a combination of documentation by the lender, written communications by the borrower or the borrower's agent (e.g., an investment banker or a broker), and documentation of the borrower showing that the loan was approved by the lender and that the offer to make the loan was received by the borrower. Such documentation would have to include the principal terms of the loan, such as the principal amount, interest rate or spread, and maturity of the loan. Of course, a loan made pursuant to such a written binding commitment would not qualify under the grandfather rule unless the proceeds of the loan are used to acquire employer securities pursuant to a written binding contract (or a tender offer registered with the Securities and Exchange Commission) in effect on June 6, 1989, and at all times thereafter before such securities are acquired.

The repeal of the dividend deduction would apply to dividends paid on stock acquired after July 10, 1989, except to the extent the dividends are paid on employer securities acquired with a loan that is grandfathered from the repeal of section 133.

The modification of the deferral of gain provision (sec. 1042) would apply to sales to an ESOP after July 10, 1989.

Revenue Effects
(Fiscal years, millions of dollars)

Proposal	1990	1991	1992	1993	1994	1990-94
1. Repeal partial interest exclusion for ESOP loans	1,265	1,705	2,080	2,325	2,660	10,175
2. Repeal deduction for dividends paid on employer securities held by an ESOP	368	464	612	724	811	2,979
3. Impose 3-year holding period on seller to be eligible for tax-free rollover	(*)	(*)	(*)	(*)	(*)	(*)

*/ Gain of less than $5 million.

B. Repeal of Transition Rule for Certain High Withholding Tax Interest

Present Law

Generally for taxable years beginning after December 31, 1986, interest income (other than export financing interest) subject to a foreign withholding tax or other gross basis tax of 5 percent or more is designated "high withholding tax interest" and subject to its own separate foreign tax credit limitation. A special transition rule applies, however, to certain interest on certain loans outstanding prior to or as of the close of the first taxable year of the taxpayer beginning after December 31, 1988, to any of 33 foreign countries (the "Baker 33") or to any resident of one of those countries for use in that country.

Under the transition rule, for a three-year period (i.e., taxable years beginning after December 31, 1986, and before January 1, 1990), foreign taxes paid with respect to interest on all loans to such foreign countries or residents (up to a limit based on 110 percent of the amount of qualified loans outstanding on November 16, 1985) are fully available to offset U.S. tax on certain foreign income (e.g., financial services income in the case of a taxpayer that is a bank) other than high withholding tax interest income. This transition rule thus grandfathers for the three-year period the interest on all loans to such borrowers that existed prior to November 16, 1985, and also prevents, during the three-year period, application of the substantive rules of the 1986 Act to taxes with respect to loans to such borrowers entered into in taxable years beginning before 1990, to the extent that the principal amounts of such loans, together with the principal amounts of any preexisting loans, do not exceed 110 percent of the principal amounts outstanding on November 16, 1985.

In each of the four years following this three-year period, an annually declining percentage of foreign taxes (80 percent in the first year, 60 in the second, 40 in the third, and 20 in the fourth) with respect to loans outstanding as of the close of the first taxable year of the taxpayer beginning after December 31, 1988 (again, subject to a limit based on 110 percent of the amount of qualified loans outstanding on November 16, 1985) may be used to offset U.S. tax on other foreign income.

Explanation of Proposal

The proposal would repeal the transition rule that delays, and then phases in, application of the separate foreign tax credit limitation with respect to high withholding tax interest received on loans involving the Baker 33 countries.

Effective Date

The provision would apply to taxable years beginning after December 31, 1989.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $263 million in 1990, $325 million in 1991, $255 million in 1992, $165 million in 1993, and $83 million in 1994.

C. Repeal of Completed Contract Method of Accounting for Long-Term Contracts

Present Law

Taxpayers engaged in the production of property under a long-term contract must compute income from the contract under either the percentage of completion method or the percentage of completion-capitalized cost method. Exceptions to these required accounting methods are provided for certain construction contracts of small businesses and certain home construction contracts.

Under the percentage of completion-capitalized cost method, a taxpayer must take into account 90 percent of the items under the contract under the percentage of completion method. The remaining 10 percent of the items under the contract must be taken into account under the taxpayer's normal method of accounting (e.g., the completed contract method of accounting). Exceptions to the 90/10 requirement are provided for certain ship construction contracts (40 percent under the percentage of completion method and 60 percent under the taxpayer's normal method of accounting) and certain residential construction contracts other than home construction contracts (70 percent under the percentage of completion method and 30 percent under the taxpayer's normal method of accounting).

Explanation of Proposal

The percentage of completion-capitalized cost method of accounting for long-term contracts would be repealed. The present-law special rules and exceptions for certain construction contracts of small businesses, qualified ship contracts, home construction contracts and residential construction contracts would be retained.

Effective Date

The proposal would apply to contracts entered into on or after July 11, 1989. The proposal would not apply to any contract entered into pursuant to a written bid or proposal submitted by a taxpayer to the other party to the contract before July 11, 1989, if the bid or proposal cannot be revoked or amended by the taxpayer at any time during the period beginning on July 11, 1989, and ending on the date that the contract was entered into.

Revenue Effect

The proposal is estimated to increase fiscal year budget receipts by $171 million in 1990; $390 million in 1991; $262 million in 1992; $116 million in 1993; and $28 million in 1994.

D. Corporate Mergers and Acquisitions Provisions[3]

1. Certain transactions involving foreign and other tax-exempt investors

a. Limit interest deductions for earnings stripping payments to related parties

Present Law

Any domestic corporation or foreign corporation subject to U.S. income tax on a net basis may deduct interest paid to related parties (to the extent otherwise allowable) without regard to whether the interest is subject to U.S. income taxation in the hands of the recipient. No deduction is generally allowable against U.S. income tax for dividends paid. Dividends paid to a foreign shareholder are generally subject to U.S. withholding tax at a 30-percent statutory rate or at the applicable treaty rate (as low as 5 percent).

Explanation of Proposal

The proposal would limit a corporate taxpayer's deductions for interest paid to certain related parties in certain transactions. Disallowed amounts would be treated as dividends. The proposal would apply only to payments of interest to recipients that are not subject to U.S. income taxation on such payments, and then only to the extent that the excess of the payor's total interest expenses over interest income is greater than 50 percent of the corporation's taxable income (determined without regard to net interest expense and net operating loss carryovers).

Effective Date

The provision would apply to interest paid or incurred after July 10, 1989, in taxable years beginning after such date, unless pursuant to a binding written contract in effect on July 10, 1989 and at all times thereafter.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $28 million in 1990, $38 million in 1991, $44 million in 1992, $47 million in 1993, and $49 million in 1994.

b. Tax stock gains of certain foreign investors

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[3] In addition to the following proposals, the proposals described under items I.B.1. (relating to certain high yield original issue discount instruments) and III.A. (regarding certain ESOP tranasactions) are considered related to this package.

Present Law

Under the Code, foreign persons are not generally subject to U.S. tax on gain realized on the disposition of stock in a U.S. corporation, unless the gain is effectively connected with the conduct of a trade or business in the United States. In addition, all current U.S. income tax treaties contain provisions to preclude the imposition of U.S. tax on such gains realized by treaty-country residents.

Explanation of Proposal

Gain realized by foreign persons on certain dispositions of stock in U.S. corporations would be subject to tax in the United States. Generally, the proposal would apply only to dispositions by persons who owned more than 10 percent of the stock in a U.S. corporation. U.S. tax would be withheld on a percentage of the gross proceeds. The proposal contemplates that there may be appropriate circumstances under which future treaties would raise the ownership threshold for imposition of the U.S. tax on gains above the statutory 10-percent level.

Effective Date

The provision would apply to gains realized after July 10, 1989, in taxable years beginning after such date, unless pursuant to a binding written contract in effect on July 10, 1990 and at all times thereafter. However, the provision would not override conflicting provisions of existing income tax treaties until after the Treasury has had a reasonable period, not to exceed three years, to renegotiate existing treaties.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually for 1990-1994.

2. Clarify Treasury regulation authority relating to debt/equity (section 385)

Present Law

The characterization of an investment in a corporation as debt or equity for Federal income tax purposes is generally determined by the economic substance of the investor's interest in the corporation. There is presently no definition in the Internal Revenue Code or the income tax regulations which can be used to determine whether an interest in a corporation constitutes debt or equity for tax purposes. Such a determination must be made under principles developed in case law. Courts have approached the issue of distinguishing debt and equity by analyzing and weighing the relevant facts and circumstances of each case.

In 1969, Congress granted the Secretary of the Treasury the authority to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated as stock or as indebtedness for Federal income tax purposes (sec. 385). The regulations were to prescibe factors to be taken into account in determining, with respect to particular factual situations, whether a debtor-creditor relationship or a corporation-shareholder relationship existed. Proposed regulations under section 385 were issued in 1980 and 1981, although they were withdrawn in 1983. To date, no additional regulations have been issued.

Explanation of Proposal

In order to afford the Treasury Department the opportunity to more accurately characterize instruments that under current-law principles cannot readily be classified wholly as debt or wholly as equity, section 385 would be amended to allow the Treasury Department to characterize an instrument having significant debt and equity characteristics as part debt and part equity.

The Treasury Department would continue to be authorized, although not required, to issue comprehensive debt-equity regulations under section 385. However, the Treasury Department would be directed to increase the issuance of IRS published rulings on debt-equity issues.

Effective Date

The provision would be effective after July 10, 1989.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually for years 1990 through 1994.

3. Require reporting to IRS of acquisitions and recapitalizations

Present Law

There is no requirement under present law that the parties to an acquisition or recapitalization transaction report to the Treasury Department information with respect to such transaction, except as incident to the filing of Federal income tax returns.

Explanation of Proposal

The Treasury Department would be directed to require reporting with respect to corporate acquisition and recapitalization transactions occurring after March 31, 1990. The information to be reported would include the identity of the parties to the transaction, the fees involved, and the change in the capital structure of the corporation. Penalties would apply for non-compliance with these reporting rules.

Effective Date

The proposal would be effective on the date of enactment.

Revenue Effect

The proposal is estimated to increase fiscal year budget receipts by less than $5 million annually for years 1990 through 1994.

4. Require Treasury study of "debt vs. equity" and integration issues

Interest on debt is generally deductible by the issuer and is includible in the income of the holder. However, in the case of tax exempt or foreign holders, the interest is not taxable with the result that neither the issuer nor the holders pay any tax on amounts distributed as interest.

The U.S. income tax system is not integrated, i.e., corporations and their shareholders are generally separate taxable entities. Thus, income earned by a corporation and distributed to shareholders may be taxed twice: once at the corporate level and again at the shareholder level when such income distributed to shareholders.

Explanation of Proposal

The Treasury Department be required to study whether the present-law distinctions between debt and equity are meaningful and whether there are cases in which it would be appropriate to limit interest deductions.

The Treasury Department would also be required to study the policy and revenue implications of proposals which would integrate the corporate and individual income tax systems, including a deduction for dividends paid by a corporation and a shareholder credit or exclusion for such dividends.

In addition, The Treasury Department would consider the policy and revenue implications of the tax treatment of corporate distributions with respect to debt and equity held by tax-exempt entities and foreign persons.

The Treasury Department would be required to report its findings and recommendations to the House Committee on Ways and Means, the Senate Committee on Finance, and the Joint Committee on Taxation no later than one year following the date of enactment of this proposal.

Effective Date

The provision would be effective on the date of enactment.

Revenue Effect

This provision will have no effect on budget receipts.

E. Use of Excess Pension Plan Assets to Pay Current Retiree Health Benefits

Present Law

Under present law, pension plan assets may not revert to an employer prior to the termination of the plan and the satisfaction of all plan liabilities. Any assets that revert to the employer upon such termination are included in the gross income of the employer and are subject to a 15-percent excise tax (sec. 4980).

Subject to certain limitations, an employer may under present law make deductible contributions to a defined benefit pension plan up to the full funding limitation. The full funding limitation is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan or (b) 150 percent of the plan's current liability, over (2) the lesser of (a) the fair market value of the plan's assets, or (b) the actuarial value of the plan's assets.

In addition, under present law, a pension plan may provide medical benefits to retirees through a section 401(h) account. The assets of a pension plan may not be transferred to a section 401(h) account without disqualifying the pension plan and subjecting the amounts transferred to the above-described income and excise taxes.

Explanation of Proposal

Under the proposal, a one-time transfer of certain assets would be permitted from a defined benefit pension plan to the section 401(h) account that is a part of such plan.

The assets transferred would not be included in the gross income of the employer nor subject to the 15-percent excise tax on reversions. The transfer would not disqualify the defined benefit pension plan, nor violate the present-law requirement that medical benefits under a section 401(h) account be subordinate to the retirement benefits under the plan. The employer would not be entitled to a deduction when such amounts are transferred into the account or when they are used to pay retiree health benefits.

In order to qualify for the tax treatment described above, the transfer of assets to a section 401(h) account would be required on or before December 31, 1991. In addition, the benefits of plan participants would be subject to the same rules that would apply if the plan had been terminated. Thus, each participant's benefits must be fully vested and an annuity must be purchased to fund such benefits.

The amount of excess assets that could be transferred and used for retiree health benefits would be limited to the

lesser of (1) the assets in excess of the full funding limitation (using 140 percent of current liability instead of 150 percent); and (2) the assets needed to satisfy current retiree health liabilities.

Current retiree health liabilities would be defined as the amount of retiree health benefits estimated to be paid or incurred by the employer during the employer's 1990 and 1991 tax year for employees who have retired as of the date of the transfer.

The amounts transferred to the section 401(h) account would be required to be used to pay current retiree health benefits. In addition, no deduction would be allowed for 1990 and 1991 for the payment of retiree health expenses except to the extent such payments exceed the amount transferred to the section 401(h) account (including any income thereon). Similarly, no contribution may be made by the employer to a section 401(h) account or a VEBA for expenses relating to retiree health benefits for the 1990 or 1991 plan years that may be funded by the excess assets transferred to the section 401(h) account. Any transferred amounts that are not expended for such liabilities are included in gross income, and are subject to the excise tax.

If an employer transfers assets under this proposal, the employer would be subject to a modified definition of full funding. For the plan year in which the transfer occurs, and for the immediately succeeding 4 plan years, the full funding limit with respect to the plan from which the assets were transferred is modified to use 140 percent (instead of 150 percent) of the plan's current liability.

Under the proposal, regardless of whether the employer transfers excess assets, no contribution would be permitted to a section 401(h) account if the employer is precluded from contributing to the pension plan containing such account because the plan has assets in excess of the full funding limitation. This rule would not apply to a transfer of assets made pursuant to the proposal.

Effective Date

The provision generally would apply to plan years beginning after December 31, 1989. With respect to the rule prohibiting contributions to section 401(h) accounts contained in fully funded plans, the proposal is effective for plan years beginning after December 31, 1989.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $286 million for 1990, $465 million for 1991, $176 million for 1992, and by less than $500,000 per year for 1993 and 1994.

F. Include Certain Deferred Compensation in Calculation of Index for FICA Wage Base

Present Law

Under present law, wages not in excess of the social security contribution and benefit base ($48,000 for 1989) are subject to FICA taxes. The social security contribution and benefit base, the benefit formula, and certain other social security program items are increased each year in accordance with increases in average total wages reported to the Secretary of the Treasury for income tax purposes. Thus, average wages for this purpose do not include deferred compensation that is not currently taxable, such as elective deferrals under a qualified cash or deferred arrangement as defined in section 401(k) of the Code.

Explanation of Proposal

Average wages would include certain deferred compensation, including (1) elective deferrals under a qualified cash or deferred arrangement (sec. 401(k)), (2) amounts contributed to a tax-sheltered annuity (sec. 403(b)), (3) benefits under unfunded deferred compensation plans of State or local governments and tax-exempt entities (sec. 457), (4) elective contributions to a simplified employee pension (sec. 408(k)(6)), (5) elective deferrals under the Federal Thrift Savings Plan, and (6) contributions to a plan described in section 501(c)(18). The effect of this proposal would generally be to increase the wage base for FICA tax purposes and to increase benefits paid to the recipients of social security. Because the proposal increases benefits paid to social security recipients, the proposal would have a long-term negative effect on the solvency of the Social Security Trust Fund.

Effective Date

The provision would apply in calculating the average wage increase which is used to determine contributions and benefits for years beginning after December 31, 1989. The increase in contributions and benefits for 1990 and 1991 would be based on an estimate of average wages as defined under the provision. According to the Social Security Administration, the estimate would result in a contributions and benefits base which is 2 percent greater than the amount that would be determined under present law.

Revenue Effect

(Fiscal years, millions of dollars)

Item	1990	1991	1992	1993	1994	1990-94
Revenue increase	400	1,100	1,100	1,100	1,100	4,800
Outlay offset	-90	-250	-450	-710	-1,020	-2,520
Net effect	310	850	650	390	80	2,280

G. Impose Gasoline Excise Tax on Arrival at Terminal

Present Law and Background

The gasoline excise tax is imposed on the removal or the sale of gasoline by the refiner, importer, or the terminal operator (Code sec. 4081(a)). The bulk transfer of gasoline to a terminal by a refiner or importer is not considered a removal or sale of gasoline by the refiner or importer. Under Treasury guidance, the tax is not imposed until the earlier of (1) a change of title within the terminal pursuant to a nonqualified sale, or (2) removal from the terminal in a transfer which is not by pipeline or marine vessel.

Between the arrival of gasoline at a terminal and its removal from the terminal, title to the gasoline may change hands many times, creating a sequence of transactions which is known as a "daisy chain." During this sequence of transactions, the identity of the company liable for the excise tax may be lost. As a result, opportunities for evasion of the tax are increased.

Explanation of Proposal

The proposal would modify present law by providing that, if not previously imposed under existing section 4081(a), the excise tax would be imposed on receipt of the gasoline at the terminal. The owner of the terminal would be primarily liable for the tax. The owner of the gasoline on its arrival at the terminal would be secondarily liable for the tax.

The tax would be applied to all deliveries of gasoline at a terminal from a pipeline or marine vessel. Gasoline delivered to the terminal by other means would have been taxed previously under existing section 4081(a).

Gasohol blenders would be allowed to purchase gasoline at reduced tax rates, under an amendment to the provisions of section 6416(b)(2), as State or local governments are allowed to do tax-free when purchasing gasoline for their exclusive use.

Effective Date

The provision would be effective on October 1, 1989.

Revenue Effect

The provision would increase fiscal year receipts by $117 million in 1990, and $60 million in each fiscal year, 1991-1994.

H. Require Corporate Estimated Tax Payment on Tax Liabilities for Certain Subchapter S Income

Present Law

In general, an S corporation is not subject to tax on its taxable income. Rather, taxable income of an S corporation flows through to its shareholders in a manner similar to a partnership. However, there are limited instances when an S corporation is subject to tax. These instances include: (1) the recognition of a built-in gain within 10 years of the date that a former C corporation elected S corporation status (sec. 1374(a)); (2) the receipt of passive investment income in excess of 25 percent of total annual gross receipts if the corporation has earnings and profits from a year in which it was not an S corporation (sec. 1375(a)); and (3) the recapture of investment tax credits claimed during a taxable year in which the corporation was not an S corporation (sec. 1371(d)).

Although situations exist for which an S corporation is liable for income tax, present law does not require the corporation to make estimated tax payments. Instead, the tax must be paid no later than the unextended due date of the S corporation tax return.

Explanation of Proposal

An S corporation would be required to make estimated tax payments if it has tax attributable to: (1) the recognition of built-in gains under section 1374(a);[4] (2) the realization of excess passive income under section 1375(a); or (3) the recapture of investment tax credits pursuant to section 1371(d). The rules contained in section 6655 for estimated tax payments by corporations would generally apply.

For purposes of the portion of required estimated tax payments attributable to built-in gains and investment tax credit recapture, an S corporation would not be able to utilize the exceptions which allow estimated tax payments to be based on the corporation's prior year tax (secs. 6655(d)(1)(B)(ii) and 6655(d)(2)(B)). The prior year's tax exception would be available to all S corporations (including "large" S corporations) with respect to the portion of required estimated tax payments attributable to excess passive income (even if there was no tax attributable to excess passive income in the prior year). In all situations, an S corporation would be able to use the annualization exception (sec. 6655(e)).

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[4] The provision also would apply to tax that is attributable to certain capital gains of S corporations pursuant to sec. 1374 as effective before the changes made by the Tax Reform Act of 1986.

Effective Date

The provision would be effective for estimated tax payments due for taxable years beginning after December 31, 1989.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $25 million in 1990 and less than $5 million annually in fiscal years 1991 through 1994.

I. Income Tax Withholding on the Wages of Certain Agricultural Workers

Present Law

In general, wages paid by an employer to an employee are subject to income tax withholding. Wages paid for agricultural labor are, however, exempt from income tax withholding (sec. 3401(a)(2)).

Certain cash wages paid for agricultural labor are subject to withholding for FICA taxes (sec. 3121(a)(8)). In general, agricultural workers are subject to FICA withholding if they earn at least $150 in annual cash remuneration or are covered because of the employer FICA withholding test, which under certain circumstances will subject employee wages to FICA withholding if the employer pays more than $2,500 during the year to all employees. Certain employees who are hand harvest laborers, are paid on a piece rate basis, commute daily to the farm from their permanent residence, and were employed in agriculture less than 13 weeks during the prior year, are exempt from FICA withholding.

Explanation of Proposal

Certain cash wages paid to agricultural workers would become subject to income tax withholding. Under the proposal, if the worker is subject to FICA withholding or if the worker works more than 20 days a year for that employer, the employee's wages would be subject to income tax withholding.

Effective Date

The provision would be effective for wages paid after December 31, 1989.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $270 million in 1990, 68 million in 1991, $21 million in 1992, $22 million in 1993, and $23 million in 1994.

J. Require Mutual Funds to Distribute 98 Percent of Ordinary Income

Present Law

In order to avoid a penalty excise tax, regulated investment companies, commonly called "mutual funds," must distribute before January 1 of any year at least 97 percent of their ordinary income earned during the prior calendar year and 98 percent of their capital gain net income for the twelve month period ending on October 31 of that year.

Explanation of Proposal

The distribution required to avoid the penalty excise tax would be increased to 98 percent of ordinary income.

Effective Date

The provision would be effective for taxable years ending after July 10, 1989.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $50 million in 1990, $5 million in 1991, $5 million in 1992, $5 million in 1993, and $5 million in 1994.

K. Require Continued Capitalization of Mutual Fund Load Charges in the Case of Certain Switches Within a Family of Funds

Present Law

A shareholder's basis in shares purchased in a regulated investment company (mutual fund) is the cost of acquiring the shares. This cost includes expenses incurred in connection with the purchase. Upon sale or exchange of the shares, the shareholder's gain is reduced, or loss is increased, by the amount of such expenses.

Some mutual fund sponsors impose an advance charge for sales fees (load charge) upon purchase of shares. Sometimes, a load charge is imposed when shares of a fund are purchased but is waived if the shares are received in exchange for those of another fund within a family of funds. Under present law, a shareholder can purchase shares of a fund, immediately exchange them for shares of a fund for which the load charge is waived, and increase loss or reduce gain by an amount equal to the load charge.

Explanation of Proposal

A load charge would not be taken into account in determining a shareholder's basis in mutual fund shares which are sold or exchanged within thirty days in a transaction that does not terminate the shareholder's reinvestment right. A reinvestment right is the right to reinvest the proceeds from the sale or exchange of the shares at a reduced charge in one or more mutual funds.

Effective Date

The provision would apply to load charges incurred after July 10, 1989, in taxable years ending after such date.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $14 million in 1990, $28 million in 1991, $13 million in 1992, $5 million in 1993 and $3 million in 1994.

L. Reduce Built-In Gain or Loss Threshold for Sections 382 and 384

Present Law

Sections 382 and 384 of the Code restrict the use of built-in losses and built-in gains of a corporation when there are certain changes in the control of the corporation. These rules apply only if the net unrealized built-in loss or built-in gain exceeds 25 percent of the fair market value of the assets of the company.

The consolidated return regulations also contain rules that restrict the use of built-in losses of a corporation in certain circumstances. These rules apply only if a 15 percent threshold is exceeded.

Under the minimum tax adjusted current earnings regime, if there is a change of ownership under section 382, all built-in losses are limited, without a threshold.

Explanation of Proposal

The restrictions in Code sections 382 and 384 on the use of built-in gains and built-in losses of a corporation would apply if the built-in loss or built-in gain exceeds the lesser of (1) 15 percent of the fair market value of the assets of the company or (2) $10 million.

A corresponding threshold would be provided under the adjusted current earnings minimum tax regime.

Effective Date

The proposal would be effective for changes in control of a corporation subject to section 382 or 384 after July 10, 1989, unless pursuant to a binding written contract in effect on or before July 10, 1989 and at all times thereafter.

Revenue Effect

The proposal is estimated to increase fiscal year budget receipts by $25 million in 1990, $42 million in 1991, $44 million in 1992, $46 million in 1993, and $49 million in 1994.

M. Improve Enforceability of Section 482 with Respect to U.S. Subsidiaries and Branches of Foreign Corporations

Present Law

The Treasury is authorized to distribute, apportion or allocate gross income, deductions, credits, or allowances between or among commonly controlled organizations, trades, or businesses as necessary to prevent the evasion of taxes or to clearly reflect income (sec. 482). Any corporation (U.S. or foreign) that conducts a trade or business in the United States and that is controlled by a foreign person must file an information return reporting all transactions with related foreign persons (sec. 6038A). Failure to comply with this reporting requirement carries a monetary penalty that can reach a maximum of $24,000. "Control" for purposes of section 6038A requires 50-percent ownership by a single foreign person (including ownership attributed to that person).

The IRS is authorized to summon certain persons to produce books, papers, records, and other data that may be relevant to the examination of any return (sec. 7602). However, such summonses may not be practically or legally enforceable in all appropriate cases, especially where summoned materials are in the possession of a foreign person.

Explanation of Proposals

Requirements imposed on taxpayers

1. Apply the reporting requirements of section 6038A to corporations that are 25-percent owned by 10-percent foreign shareholders, and to transactions involving such shareholders.

2. Require certain books, papers, records and other data (as specified in Treasury regulations) to be maintained in the United States for each transaction that is required to be reported under section 6038A ("reportable transaction").

3. Require any foreign person that is a related party of any corporation that is subject to the reporting requirements of section 6038A ("reporting corporation") to designate such corporation as its agent to accept service of process in connection with IRS summonses related to any reportable transaction.

Penalties for noncompliance

1. Increase the existing $1,000 penalty for failure to meet the requirements of section 6038A (as expanded by the proposal) to $10,000, and remove the current $24,000 ceiling on additions to that penalty.

2. Authorize the Secretary to distribute, apportion or

allocate to the reporting corporation all of the income and none of the deductions (including offsets to income for the cost of goods sold) related to a reportable transaction in the event that (a) a reporting corporation fails to comply with the reporting requirements of section 6038A after IRS notice of the failure, (b) a reporting corporation is not designated by a related foreign person as its agent to accept service of summonses, or (c) a reporting corporation and a foreign person related thereto fail to produce any books, papers, records, or other data that are properly required by the IRS in the examination of a reportable transaction.

Report to Congress

Require the IRS to report to Congress on its efforts to audit U.S. subsidiaries of foreign-based multinationals.

Effective Date

The provisions would apply to taxable years beginning after July 10, 1989.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $60 million for 1990, $80 million for 1991, $85 million for 1992, $90 million for 1993, and $95 million for 1994.

N. Modify Excess Loss Account Recapture Rules to Prevent Shifting of Basis to Debt

Present Law

Under consolidated return regulations, in general, a parent corporation must reduce its basis in the stock of a subsidiary with which it files a consolidated return by the amount of distributions the parent receives from the subsidiary and the amount of any deficit of earnings and profits of the subsidiary. The parent increases its basis in the stock of a subsidiary by the amount of contributions to the subsidiary and earnings and profits of the subsidiary. In general, when distributions and losses from the subsidiary exceed the contributions to and earnings of the subsidiary, an "excess loss account" is created. This amount is generally recaptured by the parent on certain dispositions of the stock of the subsidiary.

Under the present consolidated return regulations, a parent corporation that has an excess loss account in the stock of the subsidiary can defer recapture of such excess loss account on disposition of the subsidiary's stock by electing to apply the excess loss account to reduce the basis of other stock or debt held by the parent in the subsidiary.

Description of Proposal

The proposal would modify the excess loss account recapture rules to prevent the reallocation of the excess loss account to reduce the basis of subsidiary debt held by the parent. Thus, on disposition of the stock of a subsidiary, gain attributable to an excess loss account would be required to be recognized rather than deferred through a reduction in the basis of debt held by the parent corporation.

The Treasury Department would be directed to reexamine the rules permitting reallocation of the excess loss account to reduce the basis of other stock held in the subsidiary.

Effective Date

The provision would be effective for dispositions after July 10, 1989, unless pursuant to a binding written contract in effect on that date and at all times thereafter.

Revenue Effect

The provision is estimated to increase fiscal yuear budget receipts by $54 million for 1990, $69 million for 1991, $61 million for 1992, $52 million for 1993, and $42 million for 1994.

O. Require Basis Reduction for Nontaxed Portion of Dividends on Self-Liquidating Stock

Present Law

Under present law, corporations are entitled to a deduction equal to 70 percent of the dividends received from a domestic corporation (80 percent if the corporate shareholder owns 20 percent or more of the stock of the domestic corporation and 100 percent if the corporate shareholder owns at least 80 percent).

A corporate shareholder's basis in stock is reduced by the portion of a dividend eligible for the dividends received deduction if the dividend is "extraordinary." In general, a dividend is extraordinary if the amount of the dividend equals or exceeds 10 percent (5 percent in the case of preferred stock) of the shareholder's adjusted basis in the stock and the shareholder has not held the stock, subject to a risk of loss, for at least 2 years prior to the earlier of the date the amount or payment of the dividend is declared, announced, or agreed to (sec. 1059).

Explanation of Proposal

Dividends that represent a "return of capital" would be treated as extraordinary dividends under section 1059 (regardless of holding period), thus requiring reduction in stock basis. The rule would be applied to preferred stock if (1) when issued, such stock has a dividend rate which declines (or can reasonably be expected to decline) in the future, (2) the issue price of such stock exceeds its liquidation rights or its stated redemption price, or (3) such stock is otherwise structured to enable corporate shareholders to reduce tax through a combination of dividend received deductions and loss on the disposition of the stock.

Effective Date

The provision would apply to stock issued after July 10, 1989, unless issued pursuant to a binding written contract in effect on July 10, 1989, and at all times thereafter.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $6 million in 1990, $10 million in 1991, $11 million in 1992, $12 million in 1993, and $13 million in 1994.

P. Repeal of Special 10-Year Write-Off for Costs of Acquiring Franchises, Trademarks and Trade Names Where Payment Exceeds $100,000

Present Law

When a taxpayer purchases an intangible asset (such as a patent, know-how, or a contract right) the purchase price is generally deductible over a period no shorter than the actual determinable useful life of the asset. If the life is not determinable or is perpetual, no deduction is permitted. The actual life is a question of fact.

When a taxpayer leases an asset and pays continuing rents or royalties,(e.g., a recurring annual percentage of sales) the payments generally may be currently deducted. However, if the taxpayer pays an initial fixed sum at the start of the lease, that amount generally may not be immediately deducted but rather is deducted over the life of the lease. Again, the life of the lease is a question of fact.

Section 1253(d)(2) of the Code provides an exception to these rules in the case of a fixed-sum amount paid to acquire a franchise, trademark, or trade name, when the transferor is required to treat the payment as ordinary income (i.e., as a lease payment) rather than as capital gain i.e., as a sale payment). In such a case, section 1253(d)(2) permits such a fixed-sum payment to be deducted over no more than 10 years, regardless of the actual determinable life of the asset.

As interpreted in an Internal Revenue Service Revenue Ruling, this exception also extends to any situation where a franchise is sold by one franchisee to another in a transaction where the selling franchisee treats the transaction as a sale rather than a lease.

Explanation of Proposal

The special 10-year write-off for fixed-sum payments for franchises, trademarks and trade names would be repealed for transactions where the payment exceeds $100,000. Payments subject to this repeal would thus be deductible over the actual useful life of the asset.

Effective Date

The provision would be effective for transactions after July 10, 1989, unless pursuant to a binding written contract in effect on that date and at all times thereafter.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $55 million for 1990, $90 million for 1991, $115 million for 1992, $135 million for 1993, and $150 million for 1994.

Q. Conform Tax Years of Controlled Foreign Corporations and Foreign Personal Holding Companies to Tax Years of U.S. Shareholders

Present Law

A controlled foreign corporation is deemed to distribute certain earnings and profits to its U.S. shareholders on the last day of the controlled foreign corporation's taxable year. Similar rules apply to a foreign personal holding company. There is no requirement that the taxable year end of such foreign corporations conform to the taxable year end of their U.S. shareholders. By contrast, the ability of taxpayers to defer income inclusions by manipulating the taxable years of other pass-through entities was significantly curtailed by the 1986 Act.

Explanation of Proposal

The proposal would require the taxable year of a controlled foreign corporation to conform to the taxable year of its U.S. shareholders who in the aggregate own more than fifty percent of the total value of the outstanding stock of the controlled foreign corporation. If there is no such year, then the controlled foreign corporation would generally be required to adopt the calendar year as its taxable year.

In the case of a foreign personal holding company that is not also a controlled foreign corporation, the proposal would require the company to adopt the taxable year of its shareholders who are U.S. persons and who in the aggregate own a majority of the value of the outstanding stock of the foreign personal holding company. If there is no such year, then the foreign personal holding company would generally be required to use the calendar year.

Effective Date

The provision is effective for taxable years beginning after July 10, 1989. In the case of a controlled foreign corporation or foreign personal holding company that would be required by this proposal to change taxable years, each shareholder that would otherwise be required to include income from more than one taxable year of such corporation in any one of its taxable years would take into account the income for the short taxable year of the corporation ratably over a period not to exceed four years, beginning with its taxable year with which or within which the short taxable year of the corporation ends.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $48 million in 1990, $71 million in 1991, $71 million in 1992, $71 million in 1993, and $36 million in 1994.

R. Resourcing Income to Prevent Avoidance of Foreign Tax Credit Limitation Rules Relating to Foreign Losses

Present Law

Members of an affiliated group of corporations may file (or be required to file) consolidated returns. To be a member of an affiliated group for this purpose, a corporation must be an "includible corporation," and a controlling percentage of the stock of the corporation (unless it is the common parent) must be owned by an "includible corporation." Under section 1504(b), foreign corporations and certain other types of corporations do not qualify as includible corporations.

Each foreign tax credit limitation to which a consolidated group is subject varies directly with the ratio of (i) the foreign source taxable income of the group subject to that limitation, to (ii) the entire taxable income of the group. Under foreign tax credit limitation rules relating to foreign losses, a net loss in a separate foreign tax credit limitation category, or in the general limitation category, reduces positive foreign source taxable income in each of the other categories.

Explanation of Proposal

The proposal gives the Treasury authority to resource the income of any member of an affiliated group of corporations (defined without regard to the exceptions from the definition of includible corporation contained in section 1504(b) for foreign and certain other corporations), or to modify the consolidated return regulations, to the extent such resourcing or modification is necessary to prevent avoidance of the purposes of the foreign tax credit limitation rules relating to foreign losses. For example, where an includible corporation indirectly controls another includible corporation through a corporation that is not includible, the Treasury would be authorized to recharacterize by regulation foreign source income of the includible corporations as U.S. source income, so that the aggregate U.S. tax liability of those corporations is no less than the tax that that would be imposed if, for foreign tax credit purposes, the includible corporations had joined in filing a consolidated return.

Effective Date

The provision would be effective for taxable years beginning after July 10, 1989.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $20 million in 1990, $37 million in 1991, $41 million in 1992, $45 million in 1993, and $49 million in 1994.

S. Excise Tax on Pipe Tobacco, Snuff, and Chewing Tobacco

Present Law

Excise taxes are imposed on cigars, cigarettes, cigarette paper and tubes, pipe tobacco, snuff, and chewing tobacco. The tax on small cigarettes is 16 cents per pack of 20 cigarettes (which is equivalent to a minimum rate of $2.67 per pound). Most taxable cigarettes are small cigarettes. Pipe tobacco is taxed at 45 cents per pound; snuff is taxed at 24 cents per pound; and chewing tobacco is taxed at 8 cents per pound.

Explanation of Proposal

The proposal would impose an excise tax of $2.67 per pound on pipe tobacco, snuff, and chewing tobacco manufactured in or imported into the United States.

Tobacco subject to tax under this proposal would include all types of tobacco suitable for use in a pipe, or as snuff or chewing tobacco, regardless of how packaged or labeled.

Effective Date

The provision would be effective for pipe tobacco, snuff, and chewing tobacco removed (within the meaning of sec. 5702(k)) after September 30, 1989.

For pipe tobacco, snuff, and chewing tobacco manufactured in or imported into the United States which is removed before October 1, 1989, and held on that date for sale, the provision would impose a floor stocks tax of $2.67 per pound on such pipe tobacco, snuff, and chewing tobacco in inventory or in transit. The person holding such pipe tobacco, snuff, or chewing tobacco in stock would be liable for payment of the tax. The tax would be due and payable on November 14, 1989, in the same manner as for the tax payable with respect to pipe tobacco, snuff, or chewing tobacco removed on or after October 1, 1989.

Revenue Effect

The provision is estimated to increase net fiscal year budget receipts by $105 million in 1990, $103 million in 1991, $101 million in 1992, $98 million in 1993, and $96 million in 1994.